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OCT. 13
CHARLES ELMORE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1939

No. 39

JEAN McNEIL PEPPER,

Petitioner,

vs.

SCOTT LITTON,

In the Matter of DIXIE SPLINT COAL COMPANY, Bankrupt.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

BRIEF FOR RESPONDENT.

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INDEX.

Subject Index.

	Page
The question involved	1
Statement of the case	3
As to res judicata, estoppel, jurisdiction	4
As to the argued fraud	10
Authorities and argument	17
I. The doctrine of res judicata	17
II. Exclusive jurisdiction of bankruptcy courts	20
III. The argued fraud	22
Conclusion	27
Appendix	29
Virginia Code	29
Sec. 5184—Fraudulent acts that are void	29
Sec. 5186—Suit to avoid fraudulent acts—lien	29
Sec. 5485—Lien of execution	30
Sec. 6503—Garnishment proceedings	30
Sec. 6151—Interpleader proceeding, generally	30
Sec. 6152—Interpleader proceedings, by officer	31
Sec. 6319—Injunctions	31
Motion to dismiss	32

Table of Authorities.

American Surety Co. v. *Baldwin*, 287 U. S. 156	17
Bereth v. *Sparks* (C. C. A. 7), 51 F. (2d) 441, 80 A. L. R. 909	18
Buffum v. *Peter Barceloux Co.*, 289 U. S. 227, 234, 77 L. Ed. 1140, 1145	18
In Re: Barrett & Co., 27 F. (2d) 159	22
Cromwell v. *County of Sac*, 94 U. S. 351, 24 L. Ed. 195	17
City of Wheeling v. *John F. Casey Co.*, 89 F. (2d) 308, 310	17

Page

In re: Cherokee Public Service Co. (C. C. A. 8), 94 F. (2d) 536 17
Connell v. *Walker*, 291 U. S. 1-6, 78 L. Ed. 613 20
Comer v. *John Hancock Mut. Ins. Co.*, 80 F. (2d) 413, at 417 22
Davis v. *Wakelee*, 156 U. S. 680, 39 L. Ed. 578, 583-585 19
Dogg v. *Blair*, 139 U. S. 118, 35 L. Ed. 104, 107 24
Guettell v. *U. S.* (C. C. A. 8), 95 F. (2d) 229 17
Grant v. *Buckner*, 172 U. S. 232, 43 L. Ed. 430 21
Isaacs v. *Hobbs Tie & Timber Co.*, 282 U. S. 739, 75 L. Ed. 645 22
Johnson v. *Burke Manor Building Corporation* (C. C. A. 7), 48 F. (2d) 1031 18
Litton v. *Pepper*, 100 F. (2d) 830 2
Mays v. *Fritton*, 20 Wall. 414 21
Metcalf v. *Barker*, 187 U. S. 165, 47 L. Ed. 122 20
Moore v. *Greene*, 145 Fed. 472, 477-478 22
Moss v. *Riddle*, 5 Cranch, 351, 3 L. Ed. 123 23
North Carolina R. Co. v. *Story*, U. S. 288, 69 L. Ed. 959 19
Pepper v. *Dixie Splint Coal Company et al.*, 165 Va. 179, 181 S. E. 406 11
Rankin v. *Cox*, 71 F. (2d) 56 21
Rio Grande Irrigation Co. v. *Gildersleeve*, 174 U. S. 603, 43 L. Ed. 1103, 1106 23
Smith, Trustee, v. *Litton*, 167 Va. 263, 188 S. E. 214 2
Straton v. *New*, 283 U. S. 318, 75 L. Ed. 1060 20
Societe Fonciere et Agricole des Etats Unis v. *Milliken*, 135 U. S. 304, 34 L. Ed. 208, 210 23
Tucker v. *Foster*, 153 Va. 182 19
U. S. F. & G. Co. v. *Bray*, 225 U. S. 205, 56 L. Ed. 1055 22
Winchester v. *Heiskell*, 119 U. S. 450, 30 L. Ed. 462, 464 21
Willis v. *Blue Ridge Bank*, 153 Va. 392, 403 24

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BRIEF FOR RESPONDENT.

The Question Involved.

The question for decision is what is the estate of the bankrupt? and not whether the Litton judgment "shall be allowed for payment from the estate of Dixie Splint Coal Company, Bankrupt", as stated in the brief for appellant.

The lien of the execution on the Litton judgment was *created more than four months before bankruptcy*, and the property being admittedly of less value than the amount of the execution debt, if the execution lien is valid, the property is not a part of the estate of the bankrupt.

The writ of *fieri facias* on the Litton judgment was issued by the clerk, delivered to the sheriff, and levied on the physical property of Dixie Splint Coal Company on March 19, 1934, the property was advertised for sale by the sheriff on June 2, 1934 and sold on June 14, 1934. Dixie Splint Coal Company was adjudicated bankrupt on September 7, 1934.

The Bankruptcy Court, upon petition of Pepper, referred the question of the validity of the Litton judgment and execution to the Circuit Court of Russell County, Virginia, for decision. That Court and the Supreme Court of Appeals of Virginia held that Pepper, and Smith, Trustee, were estopped from contesting the validity of the Litton judgment and execution and thereby established the validity of the Litton lien.

Smith, Trustee v. *Litton*, 167 Va. 263; 188 S. E. 214.

The United States Circuit Court of Appeals sustained Litton's pleas of *res judicata* and remanded the case with instructions to give effect to the decision of the State court, and thereby held that the fund and property in controversy were not the estate of the bankrupt—following numerous decisions of this Court.

Litton v. *Pepper*, 100 F. (2d) 830.

Notwithstanding the fact that the Bankruptcy Court referred the question of the validity of the Litton lien to the State court for decision upon the petition of Pepper, he seeks to avoid the application of the doctrine of *res judicata* by taking the position that the Bankruptcy Court had exclusive non-delegable jurisdiction of the question, that the

decision of the State court is of no effect, that Pepper is not estopped, and that Litton is guilty of fraudulent conduct, all of which questions were fully presented to and considered by the Circuit Court of Appeals.

In addition to the plea of *res judicata*, Litton interposed, in the Bankruptcy Court, a plea of estoppel against Pepper (R. 8), upon the ground that on February 11, 1937, she filed a petition in the Bankruptcy Court asking that she be allowed to garnishee the funds in the hands of the Trustee in the Bankruptcy proceeding belonging to Scott Litton, for the purpose of collecting her judgments of $496.97 and $4,282.94, which had been recovered in the Bristol litigation. (For petition see R. 37.)

At the hearing before the Referee on August 23, 1937 (R. 67), Pepper made a motion for an appraisal of the physical property of Dixie Splint Coal Company, Inc., which had been sold on June 14, 1934, and which was involved in the interpleader proceedings in the Circuit Court of Russell County, which motion was opposed by Litton (R. 68), overruled by the Referee, and sustained by the District Judge.

While the brief for appellant states that "a fund of approximately $6,000.00 constitutes the present estate", the brief concludes with the statement that the judgment of the District Court should be affirmed. A part of the $6,000.00 fund is the residue of the proceeds of the sale of the property which the District Court held should be appraised and brought into the bankruptcy case (R. 129-131).

Statement of the Case.

The statement of the case in appellant's brief contains so many incorrect, incomplete and misleading statements, and so much argument based upon such assumed premises, that it is necessary to restate the case, but the statement will be confined to the matters which appear to be pertinent to

the question of *res judicata*, estoppel and jurisdiction, and to the question of argued, and not alleged fraud.

As to Res Judicata, Estoppel and Jurisdiction.

On March 19, 1934, more than four months before bankruptcy, the Litton writ of *fieri facias*, hereinafter referred to as execution, was delivered to the sheriff of Russell County, and on that day levied on the physical personal property of Dixie Splint Coal Company. By virtue of Section 6485 of the Code of Virginia (see Appendix) it thereby created a lien upon such physical personal property, as well as upon the intangible personal property of the execution debtor.

On June 2, 1934, the sheriff advertised such physical property for sale on June 14, 1934. On June 2, 1934, Pepper delivered an execution on her judgment to the sheriff, which was levied upon the same property. The sheriff made the sale on June 14, 1934, and on June 15, 1934, filed an interpleader proceeding pursuant to Section 6152 of the Virginia Code (See Appendix), exhibiting the two executions, stating that both Litton and Pepper claimed the funds by virtue of their respective executions, and that the Clinchfield Coal Corporation claimed $2,153.00 of the fund under a prior lien, and the sheriff paid the proceeds of the sale, $3,200.00, into court (R. 237-239).

On the same day an order was entered (R. 239) convening said parties and requiring them to appear and "state and litigate their respective claims as touching the said goods and chattels mentioned and described in the petition, and the proceeds of the sale of same, in order to a decision of their respective rights severally touching the same."

Pepper (R. 241) and Litton (R. 243) answered admitting the priority of the Clinchfield claim of $2,153.00, and Litton claiming the balance of the fund under his execution, and

Pepper referring to and relying upon her bill filed in the same court to have the Litton judgment declared void.

On June 13, 1934, Pepper had filed a bill (R. 210) in the Circuit Court of Russell County against Dixie Splint Coal Company, Litton and the sheriff, exhibiting a copy of her judgment, and of the Litton judgment and execution thereon, praying that the sheriff be enjoined from making the sale under the Litton execution on June 14, 1934, and alleging, among other things:

> "3. Dixie Sprint Coal Company, Inc., is a 'dummy' corporation, Scott Litton being the real party in interest, and the same person cannot be both plaintiff and defendant, acting in a dual capacity, adverse to the rights of creditors of the Corporation, of whom Complainant was one.
>
> "4. That said supposed confession of judgment was made with intent to hinder, delay or defraud Complainant from what she is lawfully entitled to.
>
> "5. That Dixie Splint Coal Company, Inc., is not indebted to Scott Litton in said sum of $33,568.89, or in any sum.
>
> "6. That said confession of judgment is void so far as the rights of Complainant are concerned, and in fact is void on its face, and as a matter of law."

The prayer of the bill for an injunction was not presented to any judge, and for that reason was not acted upon, notwithstanding a different conclusion might be drawn from the ambigous statement on page four of appellant's brief.

It also appears from the Pepper petition asking the Bankruptcy Court to direct the Trustee to intervene in the State court for a decision as to the validity of the Litton execution that Pepper knew on May 25 (R. 272), that the Litton execution had been levied upon the property, and that Pepper thus had twenty days within which to prepare the

bill and present the prayer for injunction to any Judge in the State of Virginia, having general jurisdiction of such matters.

Litton and the other defendants promptly filed answers denying the allegations of fraud, and other allegations of the bill (R. 219-225).

No further proceedings were had in the case until it was dismissed on motion of Pepper February 15, 1935 (R. 227), which was before the trial in the independent proceedings, which was had on February 21, 1935 (R. 355).

On July 18, 1934, an order was entered (R. 245) in the interpleader case, stating that it appeared from the answers of Litton and Pepper that the Clinchfield Coal Corporation had a prior lien on the funds paid into court by the sheriff for $2,153.00, and it was ordered that said amount of the funds be paid to Clinchfield Coal Corporation, which was done by the clerk on July 18, 1934 (R. 245-247) to A. K. Morison, General Counsel, who was also chief counsel for Pepper.

On September 7, 1934, Dixie Splint Coal Company was adjudicated a bankrupt (R. 1). On November 1, 1935, an agreed order was entered, signed by counsel for Pepper, in the interpleader proceedings directing that the $961.50 balance of the proceeds of the sale under the Litton judgment and execution be paid to the trustee in bankruptcy (R. 252-53).

On October 15, 1934 (R. 271-75), Pepper filed a petition in the Bankruptcy Court exhibiting her judgment, attacking the validity of the Litton judgment because not properly confessed, referring to her bill in the Russell Circuit Court seeking to set aside the Litton judgment, also referring to her notice of October 6, 1934, to quash the executions on the Litton judgment (R. 228-232), and stating (R. 274):

> "Petitioner is advised that it is necessary to determine the validity of the alleged judgment in favor of

Scott Litton against the Dixie Splint Coal Company for the orderly administration of the estate of the Dixie Splint Coal Company, in bankruptcy; that the validity of said judgment cannot be collaterally attacked but must be attacked directly in the court in which the said judgment was awarded."

And Pepper asked that the referee enter an order directing the trustee to appear in the Russell Circuit Court, and to submit to the jurisdiction of that court the adjudication of the validity of the Litton judgment and execution. The referee entered the order so requested October 17, 1934, without notice. At the request of Litton the order was reheard on November 8, 1934 (R. 19-25). Litton interposed the interpleader proceedings, and Pepper's actions therein, as an estoppel against her right to contest the validity of the Litton judgment and executions, and asked and urged that the referee decide the question.

At that meeting I. M. Quillen resigned as attorney for the trustee, and M. M. Heuser and C. W. Hamilton were appointed attorneys for the trustee, and directed to give the matters involved their prompt attention, and file such petition on behalf of the Trustee as they deemed advisable. On November 27, 1934 (R. 25), Heuser and Hamilton, attorneys, filed a petition or report stating "that it appears that said (Litton) judgment and executions issued thereon, and a sale made thereunder, involve the title to virtually all of the personal estate of the bankrupt as well as the real estate", and asked for permission to institute a new and independent proceeding in Russell Circuit Court to abate and set aside said judgment and all executions thereon.

On December 8, 1934, Litton filed a written answer (R. 26-28) to said petition, setting out the fact that the Pepper bill in chancery and the Pepper motion were already pending in Circuit Court of Russell County, and that one of those suits should be prosecuted rather than put him to the ex-

pense of defending another and third suit, and again relied upon his grounds of estoppel and asked that the referee decide the case.

On December 18, 1934 (R. 188-190), the referee entered an order directing Heuser and Hamilton, attorneys for the trustee, to

> "proceed to institute such suit in the Circuit Court of Russell County, Virginia, in the name of P. H. Smith, Trustee, in Bankruptcy for Dixie Splint Coal Company, Bankrupt, independent and separate from any suit that may now be pending in said court, as they shall deem necessary or advisable for the purpose of testing the validity of the judgment and any and all executions that have heretofore been issued thereon, and for any other purpose which they may deem necessary and advisable."

Contrary to the statement on page eight of appellant's brief that said order of December 18, 1934, necessarily overruled Litton's plea of estoppel against Pepper, the order neither mentioned nor overruled the plea, but on the contrary, referred the question to the Circuit Court of Russell County for decision.

Such independent proceeding was promptly instituted, and the record thereof appears in the Virginia record in this case (R. 178). The Circuit Court of Russell County and the Supreme Court of Appeals of Virginia held that Pepper was the only general creditor of the bankrupt, that the trustee represented Pepper in the proceedings, and that Pepper and the trustee were estopped to contest the validity of the Litton judgment by reason of her actions in the interpleader proceedings in the Russell Circuit Court.

While the said order of December 18, 1934 does not state that it was entered at the request of Pepper, the minutes of the meeting of November 8, 1934 (R. 19 at bottom 23) show that Pepper had asked that the independent proceed-

ing be instituted, and the controversy at that time between Pepper and Litton was that Litton desired the Bankruptcy Court to decide the question of estoppel, and, in any event that it be decided in one of the cases already instituted by Pepper in the Circuit Court of Russell County, and that Pepper had changed the request in her petition to intervene by asking (R. 23) "we desire to broaden the motion of Jean McNeil Pepper in the Bankruptcy proceeding by having it include a direction by the referee to the trustee to move the Circuit Court of Russell County, Virginia, to quash any and all executions issued by said Court on a judgment confessed by Dixie Splint Coal Company, Inc., in favor of Scott Litton, on the ground that said confession of judgment is void."

Mr. S. Bruce Jones, Counsel for Pepper, appeared for her in the Virginia litigation and actively participated in the trial (R. 319).

On November 23, 1936 (R. 34-35), Hamilton and Heuser filed their report to the referee, stating among other things:

> "Therefore, we report unto your Court that validity of the aforesaid judgment in favor of Scott Litton *v.* Dixie Splint Coal Company, Inc., in the principal sum of $33,468.89 has been established by said Scott Litton to have been regularly confessed insofar as this matter is concerned."

On August 23, 1937 (R. 6-8), Litton filed an answer pleading that the question of validity of the Litton judgment and of the executions issued thereon was *res judicata*, and that Pepper was estopped from further contesting the validity thereof. The referee sustained the plea of *res judicata;* the District Judge reversed the referee and remanded the case for further proceedings, at which further proceedings on August 10, 1938 (R. 66), Pepper made a motion for an appraisal of the property which had been

sold under the Litton execution on June 14, 1934. Litton interposed the objections of *res judicata* and estoppel, and other objections to said motion; the referee again decided that the questions raised were *res judicata;* the District Court again reversed the referee, and the United States Circuit Court of Appeals reversed the District Court and applied the doctrine of *res judicata.*

During the pendency of the bankruptcy case Pepper continued the litigation against Litton at Bristol, which had been instituted in 1931, and had recovered a judgment for costs in the Supreme Court in 1935 for $496.97 against Litton and recovered a judgment on August 8, 1936 in the Bristol Court for $4,282.94 (R. 103-105).

Pepper filed a bill of review of the decree of August 8, 1936, which was denied, and later applied to the Supreme Court of Appeals of Virginia for an appeal from the decree denying the bill of review. Before the conclusion of her efforts to get a review of the decree for judgment of August 8, 1936, Pepper on February 11, 1937 (R. 37) filed a petition in the Bankruptcy Court setting up said judgments against Litton for $496.97 and $4,282.94, and asking she be allowed to garnishee the dividends coming to Litton in the bankruptcy case. On August 23, 1937 (R. 6 at 8) Litton pleaded the filing of said petition as an admission of the validity of the Litton execution lien against Dixie Splint Coal Company as an estoppel against Pepper.

As soon as Pepper's petition for an appeal from the Bristol decree of August 8, 1936 was denied, Litton paid to Pepper the judgments of $496.97 and $4,282.94, within the fifteen days stay period provided in the said decree.

As to the Argued Fraud.

No written or oral averment or charge of fraud was made in any paper filed or statement made before the referee.

Fraud was first argued on the appeal to the District Judge in 1937, and has been argued in the successive appeals since then. New arguments of fraud have been made in desperation in the successive appeals.

It is believed that a sufficient answer to these arguments of fraud is that this Court and every Court in the land has held that one who relies upon charges of fraud must first specify the allegations of fraud in a proper pleading, and then prove the charges clearly, and since no such charges have been pleaded or proven, they should not be argued.

Pepper did allege that the Litton debt was not due, and that the Litton judgment was confessed to hinder, delay and defraud his creditors, including Pepper, in the bill filed in the Circuit Court of Russell County, Virginia, on June 13, 1934, which bill prayed that the sheriff's sale of the physical property of Dixie Splint Coal Company on June 14, 1934, be enjoined. The injunction was not applied for. The bill was made a part of the answer filed by Pepper in the interpleader proceeding instituted by the sheriff for the purpose of convening Litton and Pepper before the Court to test the validity of their respective executions. These charges and allegations of fraud were promptly abandoned, and the bill soon afterward dismissed, and no suggestion or argument of fraud was made in the bankruptcy proceeding for three years or more, and then only in argument on appeal.

However, since half of Appellant's brief is devoted to an argument of fraud on the part of Litton, it is deemed proper to reply to such argument *seriatum*.

After the decision in *Pepper* v. *Dixie Splint Coal Company et al.*, 165 Va. 179, 181 S. E. 406, the case was tried before a Bristol jury, where Pepper resided. The verdict (R. 103-105) of the jury completely vindicated Litton of all charges of fraud.

The Litton judgment was confessed June 2, 1933, which was more than eight months before the Pepper judgment for $9,000 was rendered on February 19, 1934 (R. 214). Litton had ample time to have proceeded to judgment by motion or action, and the judgment was confessed, upon advice of counsel, to save expense. The statement that "Litton falsely represented that his corporation intended to appeal from its judgment" is typical of these unfounded charges. The decree (R. 214) shows that both parties expressed a desire to appeal from the decree. Dixie Splint Coal Company was required to give a suspending bond to suspend execution on the judgment against it. No bond was required of Pepper, of course. From the motion to dismiss the appeal later taken by Pepper (see Appendix) it appears that Pepper ordered the record prepared for the purpose of applying for the appeal, and wrote counsel for the defendants on April 16, 1934, that Pepper "will not prosecute an appeal because the cost of printing the record was beyond her ability to pay", that the record had been made up, and that defendants could have the record for the amount paid therefor, $153.00; also that Pepper was having the $9,000 judgment docketed and would proceed for the collection thereof. Thereupon, relying upon said letter, the defendants decided not to proceed with the preparation of the petition for appeal from the judgment against the "Third" Dixie Splint Coal Company (*i. e.*, the $9,000 judgment). Then on August 16, 1934, three days before the expiration of the period within which the "Third" Dixie Splint Coal Company could apply for an appeal, Pepper, without notice of the change in her intention, applied for the appeal against the "First" and "Second" Dixie Splint Coal Company, but not against the "Third" Dixie Splint Coal Company, the judgment against which Pepper accepted. Thus the Dixie Splint Coal Company did not have time within which to perfect an appeal.

The Deputy Sheriff was not only not cooperating with Litton, but advertised and sold the property on June 14, 1934, and promptly interpleaded the parties as provided by statute, and caused an order to be entered by the Court convening them for the purpose of litigating their respective claims under their executions.

Another typical statement is made as an excuse for not presenting the bill for injunction, viz: "But on account of the absence of the Judge, the prayer for injunction was not acted upon." Pepper admits (R. 272) that she knew on May 25th the Litton execution had been levied on the property. She had twenty days within which to prepare and present the injunction bill to stop the sale. It was not necessary to wait until the judge of the Russell County Circuit Court was absent, because under Section 6319 of the Code (See Appendix) the bill could have been presented to Judge Roberts at Bristol, where Pepper and her counsel reside, or to Judge Robertson, at Abingdon, fifteen miles from Bristol, or to Judge Carter, at Gate City, thirty miles from Bristol, or by driving some seventy-five miles from Bristol to see the absent Judge.

The property was not purchased by Litton individually, but as agent for Dixie Splint Coal Company, afterward incorporated as Dixie-Beaver Coal Company.

The resolution pursuant to which the petition in bankruptcy was filed did not indicate that bankruptcy was then contemplated. It is found in the narrative of proceedings before the Referee, sent up as an original exhibit, page 125-C, viz:

> "A further full and complete discussion of the conditions of the corporation was gone into, and by unanimous consent the stockholders present, do hereby ratify and approve all acts of the officers in connection with the handling of the affairs of the company, and instructs them to settle up and liquidate the affairs of the corpo-

ration in as economical and thorough manner as they are able to do, and to preserve the remaining assets of the corporation for its creditors as their respective interests may appear, and to do any such other things in connection therewith as they deem prudent and wise."

Litton acquired no rights, and Pepper lost none, by reason of bankruptcy The Litton execution had been levied on the physical property, and the money in bank and main debt due the Company, had been garnished under the execution, which execution the Supreme Court of Appeals later held valid because Pepper was estopped to contest it. The apparent reason for bankruptcy was to concentrate the litigation then pending in Russell County, Bristol and Norfolk.

Said narrative of proceedings, at pages 125-A and 125-B, shows that the Clinchfield lease was released because Clinchfield Coal Corporation, by A. K. Morison, *et al.*, had given notice of the cancellation of the lease on June 2, because of default thereunder. A. K. Morison was, and is, general counsel for Clinchfield Coal Corporation, and chief counsel for Pepper in this litigation. The transfer of the tangible property to Dixie-Beaver Coal Corporation for $20,135.36 of its capital stock was made a matter of public record at the time in the office of the State Corporation Commission, as required by law.

The new lease form Clinchfield Coal Corporation to Dixie-Beaver Coal Corporation was either prepared or approved by A. K. Morison, its general counsel, and he knew what was being done at the time the charges of fraud against Pepper were made and abandoned in the chancery suit and interpleader proceedings. The suspension of the Pepper judgment for $9,000 under the suspension bond executed by Dixie Splint Coal Company expired about May 19. Pepper, by A. K. Morison, had written Litton's attorneys (See Appendix) April 16, 1934, that the judgment was being docketed and proceedings would be taken to collect it. Of the with-

drawals by Litton and Smith now complained of Litton withdrew $3,936.69 on May 31, 1934 (R. 79), and Smith withdrew $3,333.32 on or after May 31, 1934 (R. 83). So that Pepper could easily have prevented such withdrawals by garnishment proceedings, if it had been desired to do so.

The personal ledger accounts of Litton and Smith showed that each of them had been credited with salaries of $500.00 per month, and that a large part of such salaries had been paid for seven years before the Pepper claim was ever heard of.

The addresses of both Litton and Pepper were inadvertently omitted from the bankruptcy schedules. The first meeting was continued for that reason. At the creditors' meeting of November 8, 1934, at which Pepper was represented by Mr. Morison and Mr. Cantwell, the statement was made by counsel for Litton that "Pepper has never filed any proof of claim in bankruptcy till this date, *although she has had full notice and knowledge of the bankruptcy proceedings since their inception.*" (R. 21, near bottom.)

The record shows (R. 24) "the referee was informed by someone that Messrs. Warren and Cantwell represented Mrs. Pepper and the referee's recollection is that the copy of the notice adjourning the first meeting was mailed to Messrs. Warren and Cantwell, but the referee does not make this as a positive statement." Mr. Cantwell was at the meeting at which the referee made that statement.

The record shows (R. 231) that Pepper had notice on October 6, 1934 of the bankruptcy, and also on October 15 when she filed her petition asking that the trustee be directed to intervene in the litigation in the State Court (R. 271-275). She did not file her claim until November 8, when she was forced to file it to be heard upon her petition to intervene (R. 19).

Smith and Quillen were selected as trustee and attorney by creditors other than Litton, because of their familiarity

with the business. Quillen resigned as soon as the controversy developed and Smith resigned later, when requested to do so.

At this point it is proper to refer to the statement in the opinion of the Circuit Court of Appeals (R. 410, middle): "No charge was made as to the validity of Litton's claim against the corporation perhaps for the reason that P. H. Smith, who was the Secretary-Treasurer of the Corporation, and confessed the judgment on its behalf, was also the trustee in bankruptcy."

The independent proceeding was instituted by Heuser and Hamilton, without consulting Smith, who had nothing whatever to do with the preparation of the papers, and did not see them until after they were filed.

Litton did not oppose and attack on the confessed judgment. He asserted that Pepper was estopped from attacking the judgment, insisted that the referee should pass upon the question of estoppel, and that in any event if the referee did not decide the question, that the trustee should go into one of the cases already pending in the Circuit Court of Russell County, and not institute the independent proceeding.

The referee did not pass upon or overrule Litton's plea of estoppel against Pepper by the order of December 18, 1934.

Litton had a right to pay, and did personally pay, the unsecured claims against the bankrupt.

The Trustee did file a motion or independent proceeding in the Russell Circuit Court to set aside the Litton judgment upon the ground that it was void upon its face. The motion was prepared by Hamilton and Heuser without consulting the Trustee, and did not aver that the debt was not due, or that the judgment was fraudulent.

Counsel for the Trustee reported (R. 34-35) that the validity of the Litton judgment and execution had been established by the decision of the Supreme Court of Appeals

of Virginia. If Pepper thought otherwise at that time the case should have been appealed to this Court.

Authorities and Argument.

The application of the doctrine of *res judicata* appears to be decisive of the case. This point will be considered first. The discussion of this point will also be a reply to the second and third points in appellant's brief, relating to estoppel. The question of the exclusive non-delegable jurisdiction of the bankruptcy court will then be discussed, followed by a brief discussion of the question of fraud.

I.

The Doctrine of Res Judicata.

This Court in the leading American case of *Cromwell* v. *County of Sac*, 94 U. S. 351, 24 L. Ed. 195, stated the law on this subject as follows:

> "A judgment is a finality as to the claim or demand in controversy * * * not only as to every matter which was offered and received to sustain or defeat the claim or demand, but as to any other admissible matter which might have been offered for that purpose."

In addition to the cases cited in the opinion of the United States Circuit Court of Appeals, a few cases illustrating the application of the above-stated doctrine, some of them bankruptcy cases, and most of them cases in which Federal Courts have applied the doctrine to decisions of State Courts, are cited:

City of Wheeling v. *John F. Casey* Co., 89 F. (2d) 308 310;

Guettel v. *U. S.* (C.C.A.8) 95 F. (2d) 229;

American Surety Co. v. *Baldwin*, 287 U.S. 156;

In re: Cherokee Public Service Co. (C. C. A. 8), 94 F. (2d) 536;

Bereth v. *Sparks* (C. C. A. 7), 51 F. (2d) 441, 80 A. L. R. 909;

Johnson v. *Burke Manor Building Corporation*, (C.C. A.7) 48 F. (2d) 1031.

The case of *Buffum* v. *Peter Barceloux Co.*, 289 U. S. 227, 234, 77 L. Ed. 1140, 1145, is authority that Pepper is estopped.

The argument is made that because the question that the account was not justly due and that the judgment was fraudulent were not made in the independent proceeding that Pepper is not estopped from raising these points at this time. However, it is elementary that a litigant must present his whole case at one time, and if he does not do so, he will not thereafter be heard on the points not presented.

It is the duty and right of litigants, whether plaintiff or defendant, to allege and prove every point pertinent to their case. They decide what to allege and prove. If a plaintiff has three points, but elects to stand or fall on one of them, he may do so, but cannot afterwards assert the the other two points. Pepper, in June, 1934, alleged three points, viz: the debt not due Litton, fraud, and that the judgment was not confessed as provided by statute. She alleged these three points in the Chancery suit, and by reference in the Interpleader suit. She then promptly abandoned two of them, and by her acts waived the third one, and agreed that the Litton judgment and execution were valid. She thereby estopped herself from afterwards asserting any of the three points thus abandoned and waived. In her petition to the Referee she again recognized of record the fact that she had abandoned and waived the first two points, which she now attempts to reassert. She then proceeded to assist the Trustee in the independent proceeding to test the validity of the Litton judgment and execution on the only ground

she had elected to test it. If the question is not *res judicata*, and if she is not estopped, we do not see how a litigant can be estopped in any case.

The point is made in the brief for Appellant, that the judgment is void because not confessed in accordance with the Virginia statute. This Court held in *Davis* v. *Wakelee*, 156 U. S. 680, 39 L. Ed. 578, 583-585, that a party was estopped by a void judgment.

It is also claimed in Appellant's brief that the judgment of the Supreme Court of Appeals of Virginia is erroneous and of no effect. This Court held in *North Carolina R. Co.* v. Story, 268 U. S. 288, 69 L. Ed. 959, that "a judgment not appealed from, however, erroneous, is *res judicata*," hence the only way for Pepper to raise the question as to the decision of the Supreme Court of Appeals of Virginia was to have appealed the case directly to this Court.

It was decided in *Swift & Co.* v. *United States*, 276 U. S. 311, 72 L. Ed. 587, that a party cannot afterwards complain of a consent decree, although grossly erroneous.

The Circuit Court of Russell County, Virginia, had jurisdiction of the parties and of the subject matter, and the decision of that Court and of the Supreme Court of Appeals of Virginia is not only clearly correct, as will appear from a reading of the opinion of the Supreme Court of Appeals, but under the rules of comity it is binding upon this Court and all other courts.

The case of *Tucker* v. *Foster*, 153 Va. 182, is an instructive case on the application of Section 5186 of the Code of Virginia, and shows that by filing her bill alleging fraud and recording her *lis pendens*, she created a lien on the property in controversy, if she succeeded in the suit, and that she was afforded an ample and adequate remedy under the laws of Virginia to asert and enforce her rights. However, she elected to abandon her charges and is now without remedy.

II.

Exclusive Jurisdiction of Bankruptcy Courts.

It has been decided by this Court in several cases that the so-called "exclusive jurisdiction" of bankruptcy courts under Section 67-f of the Bankruptcy Act refers only to cases falling within the four months provision of that section and excludes cases wherein the lien was created more than four months before bankruptcy.

Straton v. *New*, 283 U. S. 318, 75 L. Ed. 1060.
Metcalf v. *Barker*, 187 U. S. 165, 47 L. Ed. 122.
Connell v. *Walker*, 291 U. S. 1-6, 78 L. Ed. 613.

All of these were cases of fraud, instituted under statutes similar to the Virginia statute, under which Pepper filed her bill in the Russell Circuit Court.

In a note to *Straton* v. *New*, in 75 L. Ed. 1060, reviewing the cases on this subject, it is stated (page 1072):

> "The implication from the language of the holdings of the cases warrants the conclusions that the so-called "exclusive jurisdiction" of the bankruptcy court in proper cases (*i. e.* cases falling within the four months provision) does not ipso facto oust the jurisdiction of the state court, or invalidate proceedings had thereunder; and that in the absence of interference by the bankruptcy court, or of its restraining order or other act in derogation of the exercise of jurisdiction by the state court, or where the bankruptcy court grants permission for the institution of the proceedings in the state court, the latter court has jurisdiction and right to entertain a suit to foreclose the lien and proceed to sale thereunder."

Later, this Court so decided in the above case of *Connell* v. *Walker, supra.*

In a brief for Pepper in the District Court it was stated that:

> "The confession of a judgment against itself by a corporation, amounts to a conveyance of its assets."

Section 70 (E) of the Bankruptcy Act expressly gives the State courts concurrent jurisdiction with the bankruptcy courts of suits to avoid such transfers. *Rankin* v. *Cox*, 71 F. (2d) 56.

In *Winchester* v. *Heiskell*, 119 U. S. 450, 30 L. Ed. 462, 464, this Court said:

> "The assignee in bankruptcy appeared in the State Court and litigated his rights there. This he had authority to do, and the judgment in such an action is binding on him. This we have many times decided." *Mays* v. *Fritton*, 20 Wall. 414 and citing other cases.

In *Grant* v. *Buckner*, 172 U. S. 232, 43 L. Ed. 430, this Court said:

> "The receiver voluntarily went into the State Court, and having voluntarily gone there, cannot question the right of that Court to determine the controversy between himself and the defendant. *A similar proposition was often affirmed in cases of bankruptcy, although by Section 711, Revised Statutes, the Courts of the United States are given exclusive jurisdiction 'of all matters and proceedings in bankruptcy.'*" Citing *Mays* v. *Fritton* and *Winchester* v. *Heiskell*, and continuing, "The same rule applies here. The question presented is not how the estate belonging to the receiver shall be administered, *but what is the estate belonging to him.*"

The Bankruptcy Court having submitted the question of the validity of the Litton judgment to the State court at the request of Pepper, and over the objection of Litton, the State court having decided that Pepper and the trustee have

no right to question the validity of the Litton judgment, its validity is established for all purposes.

Moore v. *Greene*, 145 Fed. 472, 477-478.

Comer v. *John Hancock Mut. Ins. Co.*, 80 F. (2d) 413, at 417.

In re: Barrett & Co., 27 F. (2d) 159.

U. S. Fidelity & Guaranty Company v. *Bray*, 225 U. S. 205, 56 L. Ed. 1055, is relied upon by appellant. In this case the Bankruptcy Court had taken jurisdiction and control of the estate of the bankrupt. Afterwards the Bankruptcy Court directed the Trustee to institute a suit in the State court, over the objection of some of the creditors. The creditors insisted upon their objection and were sustained. But, in this case Pepper petitioned the Bankruptcy Court to direct the Trustee to sue in the State court. Litton objected but did not insist upon his objection, and Pepper cannot now complain of the result.

In the case of *Isaacs* v. *Hobbs Tie and Timber Company*, 282 U. S. 739, 75 L. Ed. 645, this Court stated that in the cases in which the Bankruptcy Court had exclusive jurisdiction, the State court could not interfere *without the consent of the Bankruptcy Court.*

The law arises out of the facts. The decisions relied upon in the brief for Pepper are applicable to the facts in the cases so cited, but do not apply to the facts in this case. Here, the things now complained of were done at the request of Pepper. In the cases cited, the parties prevailing in this Court did not ask or agree that the things be done that were done, but objected, and appealed.

III.

The Argued Fraud.

Common-sense justice, as well as the due process clause of the constitution, require a litigant who intends to rely upon

fraud of which he claims his opponent is guilty, to (1) be diligent in discovering the fraud and prompt in asserting it, and (2) state specifically and clearly the fraudulent acts and prove them by clear and convincing evidence.

In this case, Pepper has made no averments of fraud, either written or oral, before the Referee, which is the Trial Court in Bankruptcy, but first made the charge by argument in the appeal to the District Judge in 1937, and almost three years after the charge, if intended to be relied upon, should have been made before the Referee.

Pepper had charged Litton with fraud in the Chancery case and in the Interpleader proceeding in the Circuit Court of Russell County in June, 1934, but promptly abandoned the charges, and agreed to the validity of the Litton judgment, in the Interpleader proceeding and dismissed the Chancery suit. She thereafter remained silent about the fraud until the brief for her was filed before the District Judge in 1937.

This Court held in *Rio Grande Irrigation Co.* v. *Gildersleeve*, 174 U. S. 603, 43 L. Ed. 1103, 1106:

> "It is also one of the principles of equity most frequently relied upon that the party seeking relief in a case like this must use due diligence in asserting his rights, and that negligence and laches in that regard are equally effectual bars to relief."

In *Societe Fonciere et Agricole des Etats Unis* v. *Milliken*, 135 U. S. 304, 34 L. Ed. 208, 210, this Court held that an unexcused delay of nearly two years in a case like this was fatal.

In *Moss* v. *Riddle*, 5 Cranch 351, 3 L. Ed. 123, it was held:

> "Fraud consists in intention, and that intention is a fact which ought to have been averred, for it is the gist of the plea and would have been traversable."

In *Fogg* v. *Blair*, 139 U. S. 118, 35 L. Ed. 104, 107, the Court said:

> "As he impugned the good faith of the transaction between the company and the contractors, it was incumbent upon him to state the essential, ultimate facts upon which his cause of action rested, and not content himself with charging, generally, that what was done was 'colorable', a 'fraud', a 'breach of trust', and a 'scheme' by which Blair and Taylor were to get the stock without paying for it. These are allegations of legal conclusions merely, which a demurrer will not admit."
> *Willis* v. *Blue Ridge Bank*, 153 Va. 392, 403.

If Pepper had made timely and specific charges of fraud against Litton, and if Litton had had an opportunity to controvert such charges in the trial court, they could not, and would not, have supported the unfair and unwarranted argument made in the brief for appellant.

When the charges of fraud which were made by Pepper against Litton in the Chancery suit and Interpleader proceedings in the State court in June, 1934, were abandoned soon after they were made, and not thereafter repeated in the proceedings before the Referee in Bankruptcy at any time; Litton and his counsel naturally did not undertake to answer or explain the arguments of fraud which were made for the first time on appeal, and have been repeated with more desperation on each successive appeal. The case has been hard fought, in at least ten suits or court proceedings, for more than eight years. The record shows that there has been no preconceived "scheme" or plan by anyone regarding the litigation at any time or stage thereof. The record reflects the opposite. The explanation of Pepper's action in charging Litton with fraud in June, 1934, when Pepper knew, or could have learned, by due diligence, in the prosecution of the Chancery suit or the Interpleader proceeding, of practically every fraudu-

lent act of which she now complains, and then promptly abandoned her charges of fraud in that litigation, and then not only remained silent about it for about three years in the proceedings before the Referee in Bankruptcy, but apparently studiously avoided raising the question in the independent proceeding in the State court, is a mystery to Litton and his counsel, unless it be explained by two things:

(1) Pepper may have been advised that she had estopped herself by her actions in the Interpleader proceeding, and hence insisted upon the Trustee instituting the independent proceeding, rather than have the question of estoppel decided by the Bankruptcy Court, or in one of the two cases she had already instituted in the State court, as Litton urged. The thought possibly being that the estoppel against her would not apply against the Trustee.

(2) Another explanation may be that in the Bristol litigation Pepper was vigorously prosecuting her suit against Litton, and apparently confidently expecting to recover a judgment against him for about $125,000. It was well known that Dixie Splint Coal Company was a small corporation, and that the coal business had been unprofitable for years, but it was apparently (erroneously) thought that Litton had accumulated considerable wealth. Let us look at the record. After the Supreme Court of Appeals of Virginia had decided the case of *Pepper* v. *Dixie Splint Coal Company et al.* in the fall of 1935, and had held Litton individually liable under the lease from the Peppers, Pepper filed a petition in the Bristol court and later a mandamus proceeding in the Supreme Court seeking to recover a judgment against Litton for $125,151.89 (R. 376). This total was made up of an item of $75,000 royalty on five hundred thousand tons of unmined coal *at the date of the complete breach of the lease contract on February 1,*

1928; interest on the $75,000 of $39,375.00, and unpaid minimum royalties and interest thereon from 1920 to 1927, inclusive, of $10,401.89 (R. 374-376). The Corporation court and the Supreme Court denied the petition. The case was tried before a Bristol jury in August, 1936, and a verdict and judgment were rendered for $4,282.94. The jury had decided that Litton was not guilty of any fraud, that the merchantable marketable coal on the Pepper property was exhausted February 1, 1928, and rendered a verdict for the balance of the minimum royalties up to the end of 1927, with interest on the minimum royalties, the total verdict being $4,282.94. Pepper delayed almost six months before filing a bill of review, which was denied, and then within the six months period allowed by law, applied to the Supreme Court of Appeals for an appeal, which was denied, during the summer of 1937.

During the period of the prosecution of this claim for around $125,000 against Litton, it was in the interest of Pepper for Litton to accumulate all the property he could, as that would make it easier for Pepper to collect her expected judgment of $125,000 against him. But when Pepper failed to recover the $125,000 judgment against Litton, she then decided to claim that Litton had been guilty of fraud *ab initio* and raised the smoke screen in the brief before the District Judge in 1937.

In this connection the Pepper petition in the mandamus case (R. 374-376) above referred to, shows that the $9,000.00 Pepper judgment against Dixie Splint Coal Company (R. 214-215) was and is an error apparent on the face of the record, because the $9,000 judgment was for minimum royalties accruing from July 1, 1928 to July 1, 1931, whereas Pepper had alleged in her cross-bill against Litton, and more clearly in the petition referred to in the mandamus case, that the entire and complete breach of the lease contract, under which Litton was held liable, occurred Febru-

ary 1, 1928. Manifestly no minimum royalty could accrue after the final and complete breach of the contract was fixed and alleged by Pepper to have occurred on February 1, 1928, so that as a matter of equity the $9,000 judgment is not due Pepper.

If a proper element of damages, the $9,000.00 item would have been included in the verdict, which was only $4,282.94, under the decision of the Supreme Court of Appeals holding Litton liable for all breaches of the lease contract. Pepper raised this point in a motion to set aside the verdict of the jury. It was denied by the trial Court and an appeal denied by the Supreme Court of Appeals.

Conclusion.

It is believed that elementary rules apply to this case. Some of these are:

(1) A litigant who feels himself aggrieved by the action or ruling of a court must object at the time, and is usually required to state the grounds of his objection, and then appeal from the ruling. Otherwise, he cannot thereafter raise the question.

(2) *A fortiori*, if and when a litigant asks or agrees that a thing be done, or acquiesces in its being done, and it is done, and he is not satisfied with the result, he cannot thereafter complain about the result, or ask that the same question be decided again.

(3) When a court refers a question to another court, having jurisdiction of the parties and subject matter, for decision, at the request of a litigant, both the rule of comity and common sense require that the court, and requesting litigant, accept the decision of the court requested to make it.

(4) A party presenting a cause of action to a court for decision cannot split the cause of action into several actions,

but must present its whole case in one action. If he elects to stand or fall on one of several grounds of his cause of action, he cannot thereafter be heard on the other grounds.

(5) A litigant will not be permitted to take inconsistent positions in the same litigation or series of litigation.

(6) A litigant who is silent when he ought to speak, will not be heard to speak when he ought to be silent.

It is respectfully submitted that the judgment of the United States Circuit Court of Appeals for the Fourth Circuit is right, and should be affirmed.

HENRY ROBERTS,
Counsel for Respondent.

October 7, 1939.

(See Appendix for relevant statutes, and copy of motion to dismiss in *Pepper* v. *Dixie Splint Coal Company et al.*)

APPENDIX.

The following sections are copied from the Virginia Code:

5184. Fraudulent Acts That Are Void; Bona Fide Purchasers Not Affected.—Every gift, conveyance, assignment, or transfer of, or charge upon, any estate, real or personal, every suit commenced, or decree, judgment or execution suffered or obtained, and every bond or other writing given with intent to delay, hinder, or defraud creditors, purchasers, or other persons, their representatives, or assigns, be void. This section shall not affect the title of a purchaser for valuable consideration, unless it appear that he had notice of the fraudulent intent of his immediate grantor or of the fraud rendering void the title of such grantor.

5186. Judgment or Decree Not Necessary Before Suit by Creditor to Avoid Gift, Transfer, et cetera, of Debtor's Estate; Measure of Relief; Extent of Lien Given Creditors; How Perfected Against Creditors and Purchasers.—A creditor before obtaining a judgment or decree for his claim may, whether such claim be due and payable or not, institute any suit which he might institute after obtaining such judgment or decree to avoid a gift, conveyance, assignment, or transfer of or charge upon the estate of his debtor declared void by either of the two preceding sections; and he may in such suit have all the relief in respects to said estate to which he would be entitled after obtaining a judgment or decree for the claim which he may be entitled to recover. A creditor availing himself of this section shall have a lien from the time of bringing his suit on all the estate, real and personal, hereinbefore mentioned, and a petitioning creditor shall be entitled to a like lien from the time of filing his petition in the court or in the clerk's office of the court in which the suit is brought. If the proceeds of sale be insufficient to satisfy the claim of all the creditors whose liens were acquired at the same time they shall be applied ratably to such claims, and the court may make a personal decree against the debtor for any deficiency remaining on the claim of any creditor after applying thereto his share of the proceeds of sale, or if he be not entitled

to share in the such proceeds, may render a personal decree against the debtor for the full amount of the creditor's claim. And in any such case if the gift, deed, assignment, transfer, or charge be declared void, the court shall allow counsel for the creditors a reasonable attorney's fee to be paid out of the proceeds of sale as other costs are paid provided the attorney's fee allowed does not affect a prior lien creditor not represented by said attorney. This section is subject to the provisions of section sixty-four hundred and sixty-nine.

6485. What a Writ of Fieri Facias May Be Levied On; From What Time It Binds; When Lien Thereof Ceases.—By a writ of fieri facias, the officer shall be commanded to make the money therein mentioned out of the goods and chattels of the person against whom the judgment is. The writ may be levied as well on the current money and bank notes, as on the goods and chattels of such person, except such as are exempt from levy under chapter two hundred and seventy-four, and shall bind what is capable of being levied on only from the time it is delivered to the officer to be executed. The lien of a writ of fieri facias under this section, on what is capable of being levied on but is not levied on under the writ on or before the return day thereof, shall cease on that day; provided, however, that property levied on, on or before the return day may be advertised and sold within a reasonable time thereafter, and the lien given by this section may also be enforced after the return day of the writ by proceedings under section sixty-five hundred and three and following of this chapter, if such proceedings be commenced before that day.

Section 6503 provides for garnishment proceedings to ascertain on what intangible personal property, etc., the lien of the execution under Section 6485 rests.

6151. The Proceedings, When Defendant Disclaims Interest in the Subject; How Right of Third Party Tried.—Upon affidavit of a defendant in any action that he claims no interest in the subject matter of the action, but that some third party has a claim thereto, and that he does not collude with such third party, but is ready to pay or dispose of the subject matter of the action as the court may direct, the

court may make an order requiring such third party to appear and state the nature of his claim, and maintain or relinquish it, and in the meantime stay the proceedings in such action. If such third party, on being served with such order, shall not appear, the court may, on proof of the plaintiff's right, render judgment for him, and declare such third party to be forever barred of any claim in respect of the subject matter, either against the plaintiff or the original defendant, or his personal representative. If such third party, on being so served, shall appear, the court shall allow him to make himself defendant in the action, and, either in said action or otherwise, cause such issue or issues to be tried as it may prescribe, and may direct which party shall be considered the plaintiff in the issues, and shall give judgment upon the verdict rendered on such trial, or if a jury be waived by the parties interested, shall determine their claims in a summary way.

6152. How Claim of Third Party Tried to Property Distrained or Levied on.—When property, of the value of more than twenty dollars, is taken under a warrant of distress, or under a writ of fieri facias issued by a justice, or when property of any value is taken under a writ of fieri facias issued by the clerk of a court, and any person, other than the party against whom the process issued, claims such property, or the proceeds or value thereof, the circuit court of the county, or the circuit or corporation court of the corporation, in which the property is taken, or the judge of such court in vacation, upon the application of the officer, where no indemnifying bond has been given, or, if one has been given, on the application of the person who claims such property and has given such suspending bond as is hereinafter mentioned, or of the party issuing said process, may cause to appear before such court as well the party issuing such process as the party making such claim, and such court may exercise, for the decision of their rights, all or any of the powers and authority prescribed in the preceding section.

INJUNCTIONS.

6319. General Jurisdiction of Judges to Award Them.—Every judge of a circuit or corporation court or of a city

court having chancery jurisdiction shall have a general jurisdiction in awarding injunctions, whether the judgment or proceeding enjoined be in or out of his circuit or city, or the party against whose proceedings the injunction be asked resides in or out of the same.

Motion to Dismiss.

(Copied from printed brief of counsel for Appellees in *Pepper* v. *Dixie Splint Coal Company, et al.*, in the Supreme Court of Appeals of Virginia, June Term, 1935.)

The appellees move to dismiss this appeal, and, for grounds for said motion, say:

The appellees' rights were prejudiced by the method adopted by the appellant in obtaining this appeal, and it should, therefore, be dismissed, for the following reasons:

First: After the lower court had rendered its decree herein, the appellee asked for a stay of execution, in order to prepare a petition for appeal. This stay was granted, and the counsel for the "Third" Dixie Splint Coal Company, a defendant in the trial court, against which alone judgment had been rendered, and hereinafter more fully described, went about preparing a petition for an appeal from said judgment, under the assumption that the appellant herein was also going to apply for an appeal.

Under date of April 16, 1934, counsel for appellees received the following letter from counsel for appellant:

"Bristol, Va., April 16, 1934.

Messrs. Greever & Gillespie,
Tazewell, Virginia,
Mr. John W. Flannagan, Jr.,
House Office Building,
Washington, D. C.

Gentlemen:

M-1321-A. P. Pepper *v.* Dixie Splint Coal Company, *et al.*

Mrs. Pepper found, after having the record made up in this case, that the cost of printing it was beyond her ability to pay, and hence she will not prosecute an appeal.

We accordingly will have Mrs. Pepper's judgment docketed, if it is necessary, and proceed for the collection of her judgment.

I have been told that the defendants desired an appeal, and if this is correct, I shall be obliged if you will notify me promptly. Incidentally, as I have stated, the record has been made up and paid for, and if you intend to appeal and desire it, Mrs. Pepper will be very glad to turn it over to you for the amount paid therefor, approximately $153.00. Please advise me promptly.

Yours very truly,

A. K. MORISON.

AKM/ms.

CC: Mr. Douglas Patterson, Bristol, Va. Mr. George M. Warren, Bristol, Va."

After receiving the above letter, it was decided not to proceed further with the preparation of the petition for appeal from the judgment against the "Third" Dixie Splint Coal Company, relying upon the representations of appellant that appellant would not appeal the case.

Thereafter, with no further notice to the defendants in the trial court, on August 16, 1934, the appellees were served with notice of appellant's application for an appeal. The date when appellant's petition for appeal was presented was three days before the expiration of the six months' period within which an appeal might have been granted said "Third" Dixie Splint Coal Company.

In part II of appellant's petition for appeal, under the heading "THE APPEAL", the appellant accepts the judgment against the "Third" Dixie Splint Coal Company, upon which judgment executions have heretofore been issued and levies made, and the entire property of the "Third" Dixie Splint Coal Company sold, and the "Third" Dixie Splint Coal Company utterly destroyed, and appeals from the final decree in part only, the appeal being taken against the "Second" Dixie Splint Coal Company, a partnership, and the "First" Dixie Splint Coal Company, a corporation.

For the appellant to be permitted to adopt this method of procedure is manifestly unjust and inadequate, for the

reason that the same individuals, in the main, were stockholders in both corporations and members of the partnership, and also because the appellant herein has thus been able to completely destroy the "Third" Dixie Splint Coal Company; and that Company, having relied upon the statement that appellant did not intend to appeal, thereby lost its right to petition for an appeal on its own account, and, not being a party to the appeal herein, the contention seems to be that it cannot assign cross-error against the appellant. It is submitted that this sort of practice by the appellant in this case should not be allowed.

To sustain the proposition that this appeal should be dismissed, the appellees cite the following authorities:

(Here follows quotations from *Gaines* v. *Merryman*, 95 Va. 660 (page 663); and *Wheeler, et al.*, v. *Thomas, et al.*, 116 Va., 259 (page 267).)

If it should be held that the foregoing statement of the procedure adopted by the appellant is not sufficient to justify a dismissal of the appeal, then, it is respectfully submitted, this Court will consider the whole record and do justice to all parties, including the "Third" Dixie Splint Coal Company, a Corporation, which the appellant evidently has tried to prevent.

SUPREME COURT OF THE UNITED STATES.

No. 39.—October Term, 1939.

Jean McNeil Pepper, Petitioner,
vs.
Scott Litton.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fourth Circuit.

[December 4, 1939.]

Mr. Justice Douglas delivered the opinion of the Court.

This case presents the question of the power of the bankruptcy court to disallow either as a secured or as a general or unsecured claim a judgment obtained by the dominant and controlling stockholder of the bankrupt corporation on alleged salary claims. The judgment of the District Court disallowing the claim was reversed by the Circuit Court of Appeals (100 F. (2d) 830). We granted certiorari because of an apparent restriction imposed by that decision on the power of the bankruptcy court to disallow or to subordinate such claims in exercise of its broad equitable powers.

The findings of the District Court, amply supported by the evidence, reveal a scheme to defraud creditors reminiscent of some of the evils with which 13 Eliz. c. 5 was designed to cope. But for the use of a so-called "one-man" or family corporation, Dixie-Splint Coal Company, of which respondent was the dominant and controlling stockholder, that scheme followed an ancient pattern.

In 1931 Pepper, the petitioner, brought suit in a state court in Virginia against Dixie Splint Coal Company and Litton, the respondent, for an accounting of royalties due Pepper under a lease.[1] While this suit was pending and in anticipation that Pepper would recover, Litton caused Dixie Splint Coal Company to confess a judgment in Litton's favor in the amount of $33,468.89, representing alleged accumulated salary claims dating back at least five years. This was done by P. H. Smith, secretary and treasurer of Dixie Splint Coal Company, who, according to the

[1] During this litigation A. P. Pepper, the plaintiff, died and the suit was continued in the name of Jean McNeil Pepper, as his executrix.

District Court, was "an employee of Litton and subservient to the latter's will." This was on June 2, 1933. Execution was issued on this judgment the same day but no return was made thereon, Litton waiting "quietly until the outcome of the Pepper suit was definitely known". On February 19, 1934, Pepper obtained a judgment against Dixie Splint Coal Company for $9,000. On motion of the company, execution on the judgment was suspended for ninety days to permit an appeal. But defendant in that suit did not appeal.[2] Instead, on March 19, 1934, while execution on the Pepper judgment was suspended, Litton caused an execution to issue on his confessed judgment and levy to be made thereunder. Yet Litton "had no intention of trying to satisfy his confessed judgment" against his corporation "unless and until it became necessary to do so"; he was using it "only as a shield against the Pepper debt". Thus, when execution and levy were made March 19, 1934, no steps were taken for over two months towards a sale of the property on which levy had been made. On May 31, 1934, Pepper caused an execution to issue on her judgment, and levy was made June 2, 1934. On this latter date the sheriff "who seems to have been cooperating with Litton" advertised the property for sale under the Litton levy made in the previous March. On June 14, 1934, the sale was held and Litton became the purchaser of the property sold at the sum of $3,200.

The next step in the "planned and fraudulent scheme" was the formation by Litton of "another of his one-man corporations", Dixie Beaver Coal Company, to which Litton transferred the property he had acquired at the execution sale at a valuation of $20,135.36 to be paid for in stock of the new company.[3]

On September 4, 1934, the third step in Litton's scheme was taken. On that date Dixie Splint Coal Company, pursuant to a resolution of the board of directors, passed June 16, 1934, (two days after the Litton execution sale) filed a voluntary petition in bankruptcy. This step, according to the findings below, was "plainly for the sole purpose of avoiding payment of the Pepper debt". The

[2] Plaintiff, however, did appeal on certain phases of the case. See Pepper v. Dixie Splint Coal Company, 165 Va. 179.

[3] The resolution of the board of directors of this new company certified that in their opinion the property "formerly owned by Dixie Splint Coal Company and now owned by Scott Litton is worth $20,135.36 in current money of the United States and we fix the value of the same at this sum, which is to be paid for in stock."

bankrupt at that time had $4,500 on bank deposit and $12,000 in accounts receivable, most of which was good. The cash on deposit was then more than sufficient to pay all creditors with the exception of Pepper. And Litton caused the voluntary petition to be filed "feeling confident that his confessed judgment would cover and consume" the remaining assets. Adjudication followed on September 7, 1934.

Litton's next step in his scheme to defeat the Pepper claim was to purchase wage claims against the bankrupt and to cause "in some manner" other claims to be withdrawn. This was done, according to the District Court, so that Pepper might be made to appear as the only general creditor—a situation designed to give Litton a decided technical advantage, as we shall see.

On June 13, 1934, Pepper had instituted suit in the Virginia state court to have the Litton judgment declared void. On June 15, 1934, the day following the sale under the Litton execution, the sheriff instituted an interpleader action joining Litton, Pepper and the Clinchfield Coal Corporation and alleging, *inter alia*, that that corporation had a prior lien on all the property sold for a debt of $2,153. Litton and Pepper both answered admitting the prior lien of the corporation, Pepper answering "without prejudice to her rights" asserted in the chancery cause to have the Litton judgment set aside. On July 18, 1934, an order in the interpleader suit was entered directing payment of $2,153.00 to the Clinchfield Coal Corporation.

Thereafter the trustee, with the authority of the bankruptcy court, moved in the state court to set aside the judgment and to quash the execution thereof on the ground that the judgment was void since it had not been confessed in the manner required by the Virginia statute.[4] The court concluded that the Litton judgment

[4] At the first meeting of creditors held on September 26, 1934, the strategic position of Litton was further improved by two other events which later the District Court quite properly denounced. In the first place, P. H. Smith, secretary and treasurer of Dixie Splint Coal Company and the one who had caused the entry of the Litton judgment on June 2, 1933, by confession against the company, was elected trustee. In the second place, Smith was authorized to employ, and did in fact employ, as attorney for the trustee, one I. M. Quillen. Quillen, or his firm, was attorney for Dixie Splint Coal Company. As such he or his firm had prepared and filed the petition in bankruptcy for the company. And he appeared at the first meeting of creditors as counsel for the bankrupt and yet at that time, as attorney for Litton, filed the claim of Litton for $33,468.89 as a preferred or secured claim. And at the time these appointments were made the controversy between Pepper and Litton over the latter's judgment was known and recognized, although formal proof of the Pepper

was void but denied the motion on the grounds that the trustee was estopped to challenge it. The court held that Pepper in the interpleader suit had treated the fund derived from the execution sale under the Litton judgment as valid and consequently had elected to recognize the validity of the judgment. Since Litton had acquired, or caused to have withdrawn, all the remaining claims against the estate, the trustee in this suit was representing only Pepper. Therefore, since Pepper was estopped, so was the trustee. On appeal that judgment was affirmed on those grounds. *Smith* v. *Litton*, 167 Va. 263.

Thereafter the question of the allowance of the Litton judgment came before the bankruptcy court on exceptions previously made by Pepper. That court concluded that the decision by the state court that the trustee was estopped to attack the Litton judgment there, did not prevent the bankruptcy court from considering its validity. It therefore reviewed all the facts and concluded (1) that Litton and the Dixie Splint Coal Company had made a "deliberate and carefully planned attempt" to avoid "the payment of a just debt"; (2) that Litton and the Dixie Splint Coal Company were "in reality the same"; and (3) that the alleged salary claims underlying the Litton judgment did not represent an "honest debt" of the bankrupt corporation, being merely bookkeeping entries for the double purpose of lessening income taxes and of enabling Litton to appear

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claim was not filed until November 8, 1934. The grave impropriety of these appointments became striking as administration of the estate was commenced.

On October 6, 1934, Pepper moved in her state court action to quash all execution issued and outstanding on the Litton judgment. Quillen, attorney for the bankruptcy trustee, appeared in opposition to the motion, acting as attorney for Litton and contended that the intervention of bankruptcy had deprived the state court of jurisdiction. The state court reserved decision. On October 15, 1934, Pepper petitioned the referee to direct the trustee to contest the Litton judgment in the state court proceeding. Quillen, stating that he acted as attorney for Litton, opposed the petition. After some delay, new counsel for the trustee were obtained who soon asked the court for authority to institute a new and independent suit in the state court to have the Litton judgment declared void. This authority was granted.

The District Court, though condemning such steps, stated it did not suggest that Smith and Quillen were acting "with any fraudulent plan or intention of utilizing their positions in aid of Litton and to the detriment of the estate". Yet he denounced the impropriety of such conduct and emphasized the incompatible and conflicting positions which these persons occupied. On the professional ethics of the conduct of Quillen, the District Court aptly observed: "It is generally accepted that an attorney for the bankrupt should not be chosen attorney for the trustee in any case. And it is even more evident that an attorney who represents a creditor whose claim is under attack should not be chosen as attorney for the trustee who, on behalf of other creditors, is charged with the duty of making that attack."

as a creditor of the corporation in case it became financially involved.[5] Accordingly, the District Court disallowed the Litton claim either as a secured or unsecured claim and directed the trustee to recover for the benefit of the estate the property or its value which Litton purchased at the execution sale on June 14, 1934. On appeal the Circuit Court of Apeals reversed that judgment holding that the decision in the state court was *res judicata* in the bankruptcy proceedings.

We think that the Circuit Court of Appeals was in error in reversing the judgment of the District Court.

In the first place, *res judicata* did not prevent the District Court from examining into the Litton judgment and disallowing or subordinating it as a claim. When that claim was attacked in the bankruptcy court Litton did not show that the proceeding in the state court was anything more than a proceeding under Virginia practice to set aside the judgment in his favor on the ground that it was irregular or void upon its face. He failed to show that the judgment in the state court was conclusive in his favor on the validity or priority of the underlying claim, as respects the other creditors of the bankrupt corporation—a duty which was incumbent on him. On the pleadings in the state court the validity of the underlying claim was not in issue. Nor was there pre-

[5] This conclusion was based on the history and nature of the claims for salary. Litton's alleged claim of $33,468.99 represented $7,427.25 owed Litton and $26,041.64 owed P. H. Smith which the latter had assigned to Litton for $1 and "other considerations" which Litton was unable to recall. As we have noted, these claims date back over a number of years. The regular salaries paid Litton and Smith were entered on the corporation's books under a "payroll" account; the salary claims here in question were carried under separate accounts, "P. H. Smith—Personal" and "Scott Litton—Personal". No sums were paid Smith from that personal account. The District Court concluded that it was hard to believe that Smith, a bookkeeper and clerk, who had been paid $2700 a year, should, with no change in the nature of his work, receive a sudden increase in salary to $8,000 a year, except upon an understanding that it was merely for record purposes and not to be paid. This conclusion was strengthened by the fact that the $26,041.64 accumulated for over five years with no effort on Smith's part to collect it and by the fact that shortly before bankruptcy he assigned the claim to Litton for a nominal consideration. As to the $7,427.25 alleged to be owed Litton the court likewise concluded that it had been entered on the books for income tax purposes and was not a "bona fide obligation" of the company. Furthermore, a substantial part of these claims was barred by the statute of limitations. On the most tolerant assumption that could be made, according to the court, the salaries credited to Litton and Smith were merely contingent or conditional obligations not provable since they were intended to be paid only whenever the profits of the company permitted. Hence they were not fixed liabilities absolutely owing. See § 63(a)(1).

sented to the state court the question of whether or not the Litton judgment might be subordinated to the claims of other creditors upon equitable principles. The motion on which that proceeding was based challenged the Litton judgment on one ground only, viz., that it was void *ab initio* because it was not confessed by Dixie Splint Coal Company in the manner required by the Virginia statute and because P. H. Smith did not have either an implied or express power to confess it. In other words, in the state court, under the pleadings and practice, the only decree which was asked or could be given in the plaintiff's favor was for cancellation of the judgment as a record obligation of the bankrupt. It is therefore plain that the issue which the bankruptcy court later considered was not an issue in the trial of the cause in the state court and could not be adjudicated there.[6] Hence, the failure on the part of Litton to establish that the state judgment was *res judicata* plus his submission of his judgment to the bankruptcy court for allowance (as a preferred claim to the extent that it was secured by the alleged lien and as a common claim as respects the deficiency) plainly left the bankruptcy court with full authority to follow the course it took and to determine the validity of Litton's alleged secured claim and the priority which should be accorded it in the distribution of the bankrupt estate. In the second place, even though we assume that the alleged salary claim on which the Litton judgment was based was not fictitious but actually existed, we are of the opinion that the District Court properly disallowed or subordinated it.

Courts of bankruptcy are constituted by §§ 1 and 2 of the bankruptcy act (30 Stat. 544) and by the latter section are invested "with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in bankruptcy proceedings." Consequently this Court has held that for many purposes "courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity". *Local Loan Co.* v. *Hunt*, 292 U. S. 234, 240. By virtue of § 2 a bankruptcy court is a court of equity at least in the sense that in the exercise of the jurisdiction conferred upon it by the act, it applies the principles and rules of

[6] It should be noted that there is authority for the conclusion that the trustee is not necessarily precluded from questioning a judgment in the bankruptcy proceedings merely because he attacked it in a state court proceeding, where the state court did not pass upon the validity of the underlying claim. In re James A. Brady Foundry Co., 3 F. (2d) 437; Gilbert's Collier on Bankruptcy (4th ed.) § 1247.

equity jurisprudence. *Larson* v. *First State Bank of Vienna, S. D.*, 21 F. (2d) 936, 938. Among the granted powers are the allowance and disallowance of claims;[7] the collection and distribution of the estates of bankrupts and the determination of controversies in relation thereto;[8] the rejection in whole or in part "according to the equities of the case" of claims previously allowed;[9] and the entering of such judgments "as may be necessary for the enforcement of the provisions" of the act.[10] In such respects the jurisdiction of the bankruptcy court is exclusive of all other courts. *United States Fidelity and Guaranty Company* v. *Bray*, 225 U. S. 205, 217.

The bankruptcy courts have exercised these equitable powers in passing on a wide range of problems arising out of the administration of bankrupt estates.[11] They have been invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done. By reason of the express provisions of § 2 these equitable powers are to be exercised on the allowance of claims, a conclusion which is fortified by § 57(k).[12] For certainly if, as provided in the latter section, a claim which has been allowed may be later "rejected in whole or in part, according to the equities of the case", disallowance or subordination in light of equitable considerations may originally be made.

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[7] Section 2(2). The sections are cited as they were at the time of the bankruptcy in this case. But the amendments made by the Chandler Act (52 Stat. 840), approved June 22, 1938, are not material so far as the issues here involved are concerned.

[8] Section 2(7).

[9] Section 57(k).

[10] Section 2(15).

[11] Thus the bankruptcy court has been held to have jurisdiction over a supplemental and ancillary bill to enjoin a creditor, after adjudication and discharge of the bankrupt, from prosecuting his claim in a state court. Local Loan Co. v. Hunt, *supra*. As a court in equity it has been held to have the power to protect the bankrupt estate against a fraudulent assessment; Cross v. Georgia Iron & Coal Co., 250 Fed. 438; to compel execution of a deed to make the bankrupt's equitable title a complete legal title; Dearborn Electric Light & Power Co. v. Jones, 299 Fed. 432; to recover assets of the estate which have been used to pay dividends under a composition order later reversed; In re Lilyknit Silk Underwear Co., Inc., 73 F. (2d) 52. And even though the act provides that claims shall not be proved against a bankrupt estate subsequent to six months after the adjudication, the bankruptcy court in the exercise of its equitable jurisdiction has power to permit claims to be proved thereafter in order to prevent a fraud or an injustice. Williams v. Rice, 30 F. (2d) 814; In re Pierson, 174 Fed. 160; Larson v. First State Bank, *supra*; Burton Coal Co. v. Franklin Coal Co., 67 F. (2d) 796.

[12] Section 57 (k) provides: "Claims which have been allowed may be reconsidered for cause and reallowed or rejected in whole or in part, according to the equities of the case, before but not after the estate has been closed."

Hence, this Court has held that a bankruptcy court has full power to inquire into the validity of any claim asserted against the estate and to disallow it if it is ascertained to be without lawful existence. *Lesser* v. *Gray*, 236 U. S. 70. And the mere fact that a claim has been reduced to judgment does not prevent such an inquiry. As the merger of a claim into a judgment does not change its nature so far as provability is concerned, *Boynton* v. *Ball*, 121 U. S. 457, so the court may look behind the judgment to determine the essential nature of the liability for purposes of proof and allowance. *Wetmore* v. *Markoe*, 196 U. S. 68. It may ascertain the validity of liens, marshal them, and control their enforcement and liquidation. *Isaacs* v. *Hobbs Tie & Timber Company*, 282 U. S. 734. And the bankruptcy trustee may collaterally attack a judgment offered as a claim against the estate for the purpose of showing that it was obtained by collusion of the parties or is founded upon no real debt.[13]

That equitable power also exists in passing on claims presented by an officer, director, or stockholder in the bankruptcy proceedings of his corporation. The mere fact that an officer, director, or stockholder has a claim against his bankrupt corporation or that he has reduced that claim to judgment does not mean that the bankruptcy court must accord it *pari passu* treatment with the claims of other creditors. Its disallowance or subordination may be necessitated by certain cardinal principles of equity jurisprudence. A director is a fiduciary. *Twin-Lick Oil Company* v. *Marbury*, 91 U. S. 587, 588. So is a dominant or controlling stockholder or group of stockholders. *Southern Pacific Company* v. *Bogert*, 250 U. S. 483, 492. Their powers are powers in trust. See *Jackson* v. *Ludeling*, 21 Wall. 616, 624. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corportion is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. *Geddes* v. *Anaconda Copper Mining Company*, 254 U. S. 590, 599. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain.[14] If it does

[13] Chandler v. Thompson, 120 Fed. 940; In re Thompson, 276 Fed. 313; In re Continental Engine Co., 234 Fed. 58. This is of course in absence of a plea of *res judicata*.

[14] This Court said in Twin-Lick Oil Company v. Marbury, *supra*, p. 590: "So, when the lender is a director, charged, with others, with the control and management of the affairs of the corporation, representing in this regard the

not, equity will set it aside. While normally that fiduciary obligation is enforceable directly by the corporation, or through a stockholder's derivative action,[15] it is, in the event of bankruptcy of the corporation, enforceable by the trustee.[16] For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation[17]—creditors as well as stockholders.

As we have said, the bankruptcy court in passing on allowance of claims sits as a court of equity. Hence these rules governing the fiduciary responsibilities of directors and stockholders come into play on allowance of their claims in bankruptcy. In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate.[18] And its duty so to do is especially clear when the claim seeking allowance accrues to the benefit of an officer, director, or stockholder. That is clearly the power and duty of the bankruptcy courts under the reorganization sections. In *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307, this Court held that the claim of Standard

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aggregated interest of all the stockholders, his obligation, if he becomes a party to a contract with the company, to candor and fair dealing, is increased in the precise degree that his representative character has given him power and control derived from the confidence reposed in him by the stockholders who appointed him their agent. If he should be a sole director, or one of a smaller number vested with certain powers, this obligation would be still stronger, and his acts subject to more severe scrutiny, and their validity determined by more rigid principles of morality, and freedom from motives of selfishness."

[15] Converse v. United Shoe Machinery Co., 209 Mass. 539. Davenport v. Dows, 18 Wall. 626. It is also clear that breach of that fiduciary duty may also give rise to direct actions by stockholders in their own right. Strong v. Repide, 213 U. S. 419. Cf. Green v. Victor Talking Machine Co., 24 F. (2d) 378.

[16] Section 70(a)(6); Manning v. Campbell, 264 Mass. 386; Stephan v. Merchants Collateral Corp., 256 N. Y. 418; Dean v. Shingle, 198 Cal. 652.

[17] See Wyman v. Bowman, 127 Fed. 257, 274; Burnes v. Burnes, 137 Fed. 781; Texas Auto Co. v. Arbetter, 1 S. W. (2d) 334, 339; McCandless v. Furland, 296 U. S. 140; Jackson v. Ludeling, *supra*, pp. 624 *et seq.*

[18] Thus in National Cash Register Co. v. Dallen, 76 F. (2d) 867, the bankrupt, prior to bankruptcy, turned in to petitioner an old cash register as a credit on account of the purchase of a new one. Pending delivery of the new machine, petitioner loaned the bankrupt another one and after the bankruptcy adjudication sought to reclaim the loaned machine. The court affirmed an order of the District Court allowing the reclamation on condition that petitioner first deliver to the bankrupt the old machine or pay the amount of its agreed value. The court said, p. 868, "We do not think it necessary to determine whether the contract for the purchase of the new cash register amounted to a bailment lease or a conditional sale. Bankruptcy courts may apply rules regulating equitable actions."

against its subsidiary (admittedly a claim due and owing) should be allowed to participate in the reorganization plan of the subsidiary only in subordination to the preferred stock of the subsidiary. This was based on the equities of the case—the history of spoliation, mismanagement, and faithless stewardship of the affairs of the subsidiary by Standard to the detriment of the public investors. Similar results have properly been reached in ordinary bankruptcy proceedings. Thus, salary claims of officers, directors, and stockholders in the bankruptcy of "one-man" or family corporations have been disallowed or subordinated where the courts have been satisfied that allowance of the claims would not be fair or equitable to other creditors.[19] And that result may be reached even though the salary claim has been reduced to judgment.[20] It is reached where the claim asserted is void or voidable because the vote of the interested director or stockholder helped bring it into being or where the history of the corporation shows dominancy and exploitation on the part of the claimant.[21] It is also reached where on the facts the bankrupt has been used merely as a corporate pocket of the dominant stockholder, who, with disregard of the substance or form of corporate management, has treated its affairs as his own.[22] And so-called loans or advances by the dominant or controlling stockholder will be subordinated to claims of other creditors and thus treated in effect as capital contributions by the stockholder not

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19 In re Burntside Lodge, Inc., 7 F. Supp. 785. In that case the court said, p. 787:

"The relations of a stockholder to a corporation and to the public require good faith and fair dealing in every transaction between the stockholder and the corporation which may injuriously affect the rights of creditors and the general public, and a careful examination will be made into all such transactions in the interests of creditors.

"If the business had not been incorporated and the Cooks had conducted the enterprise personally, they would not have been allowed compensation for services in the event of bankruptcy, and there is no cogent reason why they should be paid when the same service is rendered as an officer and manager of a corporation of their own creation and to serve their own interests. To allow claims under such circumstances in effect would permit bankrupts to collect on claims against their own bankrupt estate. It would give effect to form rather than to substance, to the letter of the law rather than the spirit and purpose of it."

20 In re Wenatchee-Stratford Orchard Co., 205 Fed. 964.

21 In re McCarthy Portable Elevator Co., 196 Fed. 247, aff'd 201 Fed. 923.

22 In re Chas. K. Horton, Inc., 22 F. Supp. 905; In re Kentucky Wagon Mfg. Co., 71 F. (2d) 802; Forbush Co. v. Bartley, 78 F. (2d) 805; Clere Clothing Co. v. Union Trust & Savings Bank, 224 Fed. 363.

only in the foregoing types of situations but also where the paid-in capital is purely nominal, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder as a loan.[23]

Though disallowance of such claims will be ordered where they are fictitious or a sham,[24] these cases do not turn on the existence or non-existence of the debt. Rather they involve simply the question of order of payment.[25] At times equity has ordered disallowance or subordination by disregarding the corporate entity.[26] That is to say, it has treated the debtor-corporation simply as a part of the stockholder's own enterprise, consistently with the course of conduct of the stockholder. But in that situation as well as in the others to which we have referred, a sufficient consideration may be simply the violation of rules of fair play and good conscience by the claimant; a breach of the fiduciary standards of conduct which he owes the corporation, its stockholders and creditors. He who is in such a fiduciary position cannot serve himself first and his *cestuis* second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters.[27] He cannot by the use of the corporate device avail himself of privileges normally permitted outsiders in a race of creditors. He cannot utilize his inside information and his strategic position for his own preferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do di-

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[23] Albert Richards Co., Inc. v. The Mayfair, Inc., 287 Mass. 280. Cf. Erickson v. Minnesota & Ontario Power Co., 134 Minn. 209; Oriental Investment Co. v. Barclay, 64 S. W. 80 (Tex. Civ. App.); Joseph R. Foard Co. v. State, 219 Fed. 827.

[24] New York Trust Co. v. Island Oil & Transport Corp., 34 F. (2d) 655; In re H. Hicks & Son, Inc., 82 F. (2d) 277.

[25] See comment in 45 Yale L. Journ. 1471.

[26] In re Otsego Waxed Paper Co., 14 F. Supp. 15. The court said, p. 16, "The applicable principle is that, where a corporation is so organized and controlled as to make it a mere instrumentality or adjunct of another, and the subsidiary becomes bankrupt, the parent corporation cannot have its claim paid until all other claims are first satisfied." See also Hunter v. Baker Motor Vehicle Co., 225 Fed. 1006; Henry v. Dolley, 99 F. (2d) 94.

The same result has been reached in equity receiverships. Central Vermont Ry. Co. v. Southern New England R. Corporation, 1 Fed. Supp. 1004, aff'd 68 F. (2d) 460; S. G. V. Co. v. S. G. V. Co., 264 Pa. 265.

A fortiori that result is reached where there is a fraudulent purpose. E. E. Gray Corp. v. Meehan, 54 F. (2d) 223.

[27] See Alexander v. Theleman, 69 F. (2d) 610, 613.

rectly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandisement, preference, or advantage of the fiduciary to the exclusion or detriment of the *cestuis*. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation.

On such a test the action of the District Court in disallowing or subordinating Litton's claim was clearly correct. Litton allowed his salary claims to lie dormant for years and sought to enforce them only when his debtor corporation was in financial difficulty. Then he used them so that the rights of another creditor were impaired. Litton as an insider utilized his strategic position for his own preferment to the damage of Pepper. Litton as the dominant influence over Dixie Splint Coal Company used his power not to deal fairly with the creditors of that company but to manipulate its affairs in such a manner that when one of its creditors came to collect her just debt the bulk of the assets had disappeared into another Litton company. Litton, though a fiduciary, was enabled by astute legal manoeuvering to acquire most of the assets of the bankrupt not for cash or other consideration of value to creditors but for bookkeeping entries representing at best merely Litton's appraisal of the worth of Litton's services over the years.

This alone would be a sufficient basis for the exercise by the District Court of its equitable powers in disallowing the Litton claim. But when there is added the existence of a "planned and fraudulent scheme", as found by the District Court, the necessity of equitable relief against that fraud becomes insistent. No matter how technically legal each step in that scheme may have been, once its basic nature was uncovered it was the duty of the bankruptcy court in the exercise of its equity jurisdiction to undo it. Otherwise, the fiduciary duties of dominant or management stockholders would go for naught; exploitation would become a substitute for justice; and equity would be perverted as an instrument for approving what it was designed to thwart.

The fact that Litton perfected his lien more than four months preceding bankruptcy is no obstacle to equitable relief. In the first place, that lien was but a step in a general fraudulent plan which

must be viewed in its entirety. The subsequent sale cannot be taken as an isolated step unconnected with the long antecedent events, all designed to defeat creditors. *Buffum, Trustee in Bankruptcy* v. *Peter Barceloux Co.*, 289 U. S. 227, 232-233. In the second place, Litton is seeking approval by the bankruptcy court of his claim. The four months' provision of the bankruptcy act is certainly not a statutory limitation on equitable defenses arising out of a breach of fiduciary duties by him who seeks allowance of a claim.

In view of these considerations we do not have occasion to determine the legitimacy of the "one-man" corporation as a bulwark against the claims of creditors.[28]

Accordingly the judgment of the Circuit Court of Appeals is reversed and that of the District Court is affirmed.

Reversed.

A true copy.

Test:

Clerk, Supreme Court, U. S.

[28] On this point the District Court said: "An examination of the facts disclosed here shows the history of a deliberate and carefully planned attempt on the part of Scott Litton and Dixie Splint Coal Company to avoid the payment of a just debt. I speak of Litton *and* Dixie Splint Coal Company because they are in reality the same. In all the experience of the law, there has never been a more prolific breeder of fraud than the one-man corporation. It is a favorite device for the escape of personal liability. This case illustrates another frequent use of this fiction of corporate entity, whereby the owner of the corporation, through his complete control over it, undertakes to gather to himself all of its assets to the exclusion of its creditors."